



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	5/17/01	Bill No:	SCA 1xx
Tax:	Property	Author:	Poochigian
Board Position:		Related Bills:	SCA 1x (Poochigian) SB 877 (Poochigian)

BILL SUMMARY

This bill would place a constitutional amendment before voters to create a new construction exclusion for 1) energy efficiency improvements to real property and 2) improvements that generate electricity for use on that real property.

ANALYSIS

Current Law

Under existing law, the construction, installation, or modification of a fixture or improvement to real property that is undertaken for the primary purpose of increasing the energy efficiency of that real property could be considered new construction. Additionally, the construction or installation of improvements that generate electricity could also be considered new construction. The law requires that when new construction occurs the total assessed value of the property must be increased by an amount equal to the added value of the construction.

Currently, no special assessment provisions exist for real property fixtures or real property improvements undertaken for energy efficiency or energy generation.

Proposed Law

This constitutional amendment would, subject to voter approval, amend Section 2 of Article XIII A of the California Constitution to provide that the term "newly constructed" does not include the construction, installation, or modification of a fixture or improvement to real property that is undertaken for the primary purpose of increasing the energy efficiency of that real property or generating electricity, including renewable electricity generation, for use on that real property. The "energy efficiency" of real property would be increased if the construction, installation, or modification will result in a reduction in the consumption on that property of heat, process heat, space heating, water heating, steam, space cooling, refrigeration, mechanical energy, natural gas, or electricity.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

In General

Property Tax System. Article XIII, §1 of the California Constitution provides that all property is taxable, at the same percentage of “fair market value,” unless specifically exempted, or authorized for exemption, within the Constitution. Article XIII A, §2 of the California Constitution defines “fair market value” as the assessor’s opinion of value for the 1975-76 tax bill, or, thereafter, the appraised value of property when purchased, newly constructed, or a change in ownership has occurred. This value is generally referred to as the “base year value”. Barring actual physical new construction or a change in ownership, annual adjustments to the base year value are limited to 2% or the rate of inflation, whichever is less. Article XIII A, §2 provides for certain exclusions from the meaning of “change in ownership” and “newly constructed” as approved by voters via constitutional amendments.

New Construction. The constitution does not define the term “new construction.” Revenue and Taxation Section 70 defines it, in part, to mean:

Any addition to real property, whether land or improvements (including fixtures), since the last lien date.

Any alteration of land or improvements (including fixtures) since the lien date that constitutes a “major rehabilitation” or that converts the property to a different use. A major rehabilitation is any rehabilitation, renovation, or modernization that converts an improvement or fixture to the substantial equivalent of a new improvement or fixture.

With respect to any new construction, the law requires the assessor to determine the added value upon completion. The value is established as the base year value for those specific improvements and is added to the property’s existing base year value. When new construction replaces existing improvements, the value attributable to those preexisting improvements is deducted from the property’s existing base year value. (R&T Code §71)

New Construction Exclusions. Over the years, Article XIII A, §2 of the Constitution has been amended to specifically exclude certain types of work from assessment as “new construction.” Consequently, while these improvements may increase the value of the property, the additional value is exempt from taxation.

Proposition	Election Ballot	Subject	R&T Code
8	November 1978	Reconstruction After Disaster	§70(c)
7	November 1980	Solar Energy Systems	§73
23	June 1984	Seismic Safety – Unreinforced Masonry Structures	§70(d)

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Proposition	Election Ballot	Subject	R&T Code
31	November 1984	Fire Safety Systems	§74
110	June 1990	Disabled Accessibility Improvements – Homes	§74.3
127	November 1990	Seismic Safety - Retrofitting & Hazard Mitigation	§74.5
177	June 1994	Disabled Accessibility Improvements – All Property	§74.6
1	November 1998	Reconstruction After Environmental Contamination	§69.4

Some constitutional amendments proposing new construction exclusions post-Proposition 13 have, at least initially, failed. Those include:

Proposition 5 in 1980 to exclude reconstruction after a non-Governor declared disaster and seismic safety new construction exclusion. (Seismic safety exclusions were subsequently approved by Propositions 23 in 1984 and Proposition 127 in 1990.)

Proposition 7 in 1982 for fire sprinkler systems. (Subsequently approved by Proposition 31 in 1984)

Proposition 34 in 1984 for additions, alternations and rehabilitation of owner occupied historical homes.

Proposition 178 in 1994 for water conservation equipment.

Fixtures. A fixture is an item of personal property that once affixed to the property shifts in classification from personal property to real property. A three-part test is used to determine whether an item is a fixture:

1. The manner of annexation or attachment of the property.
2. The degree to which the item is customized to a particular location.
3. The intention of the taxpayer in installing the property.

Business Personal Property. Personal property used in a trade or business is generally taxable, and its cost must be reported annually to the assessor on the business property statement as provided for in Revenue and Taxation Code Section 441. Personal property is not subject to the valuation limitations of Proposition 13. It is valued each lien date at current fair market value.

Generally, the valuation of personal property is based on the acquisition cost of the property. The acquisition cost is multiplied by a price index, an inflation trending factor based on the year of acquisition, to provide an estimate of its replacement cost new. The replacement cost new is then multiplied by a depreciation index, also called percent

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good tables, to provide an estimate of the depreciated replacement cost of the property (replacement cost new less depreciation). The replacement cost new less depreciation value becomes the taxable value of the property for the fiscal year.

COMMENTS

1. **Sponsor and purpose.** The author is the sponsor of this measure. Its purpose is to ensure that property taxes do not increase after energy efficiency improvements are made. It would also encourage energy independence for users who are able to acquire or construct self-generating equipment.
2. **Electricity Generating Improvements.** The new construction exclusion would apply to the construction, installation, or modification of a fixture or improvement to real property that is undertaken for generating electricity for use on that real property. This would extend the exclusion to such items as co-generation facilities, fuel cells, microturbines, biomass-based energy system or small windmill turbines that are classified as real property or a real property fixture. (The exclusion would not apply to items that generate electricity that are classified as personal property.)
3. **Clarification – Extent of Exclusion.** As currently drafted, it could be argued that the exclusion applies to generation improvements installed where the electricity generated on the property is sold in addition to being used on the property. To avoid any ambiguity over the author's intent with respect to the extent of the proposed exclusion as it relates to electricity generation property, further amendments are suggested. (The revenue estimate in the analysis is based on the assumption that the proposal does not apply to power plants built for the purpose of generating energy primarily for sale or transmission to electrical energy providers.)
4. **Exclusion Remains In Effect Until A Change In Ownership.** Generally, new construction exclusions remain in effect until the property changes ownership, at which point the property, including the portion of the property (or additional value) previously exempted from taxation via a new construction exclusion, is subject to reassessment at current market value pursuant to the change in ownership provisions of Proposition 13.
5. **Real Property, Fixtures, Personal Property, Machinery and Equipment.** New construction is a term applied to the assessment of real property, which includes fixtures. Therefore, this bill would exempt from taxation qualifying improvements if classified as real property or a real property fixture, but does not provide for its exemption for items classified as personal property. (Personal property exemptions do not require a constitutional amendment.) With property used in a business, determining whether an item should be classified as a real property fixture or personal property is often a difficult task that requires the use of judgment. The classification of property as either a real property fixture or personal property is an area of frequent dispute between assessors and taxpayers because the line of demarcation between real and personal property is not always clear. The exemption of property only if classified as a fixture will likely increase such disputes.

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6. **Existing law provides an exclusion for active solar energy systems.** This exemption is found in Revenue and Taxation Code 73, which implements Proposition 7. However certain items, namely, solar water heaters and swimming pool heaters, are excluded. This bill would allow these items to qualify for a new construction exclusion.
7. **Most types of improvements made to residential property would not be assessed as new construction under existing assessment practices.** For instance, replacing windows, adding insulation, replacing heating, ventilating and air conditioning systems (HVAC), replacing appliances, weatherizing improvements, and installing more efficient lighting are generally considered normal maintenance and repair. With residential property, an exception would be solar water heaters and swimming pool heaters as previously noted.
8. **Generally, fixtures and real property improvements reported on the annual business property statement would be more likely to be assessable as new construction and thus qualify for the proposed exclusion.** Annual reporting requirements and the audit program related to business, commercial and industrial properties, generally lead to the discovery of these types of improvements.
9. **In addition to energy conservation improvements which will be made solely because of the current high cost of gas and electricity, there are numerous legislative proposals to provide added incentives in the form of income tax credits, sales tax exemptions, grants, and no or low interest loans.** The various legislative proposals relate to both general and specific types of energy conservation improvements. Examples include:
 1. Installing real time meters
 2. Replacing appliances with more energy efficient models
 3. Retrofitting refrigeration units
 4. Installing renewable energy systems
 5. Installing solar energy systems
 6. Installing thermal energy solar technologies in commercial buildings
 7. Improving and installing demand responsiveness technologies to HVAC systems
 8. Installing commercial lighting efficiency technologies
 9. Retrofitting pumps and motors in oil and natural gas production
10. **Related Legislation.** This bill is identical to SCA 1X (Poochigian) of the first extraordinary session, which ended on May 14, 2001.

SB 877 (Poochigian) would exempt from the sales tax purchases of qualified cogeneration equipment, as defined, for use on dairy farms, and would also authorize an income tax credit for an amount equal to the portion of property taxes attributable to those fixtures and improvements to a dairy farm utilized in the cogeneration or transformation of dairy industry by-products into fuel sources used for the operation of that dairy farm.

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COST ESTIMATE

The Board would incur some minor absorbable costs to inform and advise local county assessors, the public, and staff if voters approve this constitutional amendment.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Under current law, "new construction" includes any physical alteration of an improvement that converts the improvement, or a portion of it, to the substantial equivalent of a new structure or changes the way in which the portion of the structure that was altered is used. "New construction" excludes alterations performed for the purpose of normal maintenance and repair.

Many of the alterations that might be undertaken to increase energy efficiency would fall under normal maintenance and repair. These would include adding insulation, upgrading or replacing windows and doors, replacing the heating and cooling systems, weatherization improvements, and installing more efficient lighting. For residential property, energy modifications that may be "new construction" include the addition of a freestanding stove or a fireplace insert. It is difficult to foresee how many modifications like these would take place in the future but it is likely that the number will be very small and that the amount of value added for the new construction would also be small.

For non-residential property, including commercial/industrial and agricultural, energy efficiency modifications that may be classed as "new construction" include installing of new skylights, replacing the lighting system, installing a "false" ceiling, replacing an irrigation system using an electric pump with a drip irrigation system, or replacing the electric irrigation pump with a diesel pump, and replacing dairy equipment. Staff is unable to predict how many of these modifications would take place with the primary purpose to increase the energy efficiency of the property.

Under current law the replacement of heavy industrial machinery classified as fixtures is considered "new construction." This bill would exclude replacement equipment from new construction if the reason for the replacement of the old equipment is to reduce energy costs. It is difficult to predict the amount of fixtures that would be replaced primarily to improve energy efficiency or to estimate the amount of value that would be added for this type of "new construction." Since, statewide, the total assessed value of fixtures exceeds \$70 billion and virtually all of them will have to be replaced some time in the future, it is likely that the impact for this type of "new construction" will be substantial. For example, if it is assumed that just five percent of all fixtures were replaced each year to improve energy efficiency and the value of the new fixtures was twenty percent greater than that of the fixtures they replaced, the annual revenue decrease at the basic one percent property tax rate would be:

$$(\$70 \text{ billion} \times 5 \text{ percent} \times 20 \text{ percent}) \times 1 \text{ percent} = \$7 \text{ million annually}$$

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Since the assessed values for fixtures are usually based on their depreciated costs instead of the factored base year value, the actual difference between the values of the old and new would in all likelihood be much higher and, for equipment near the end of its economic life, could exceed 1,000 percent.

The revenue decrease due to excluding energy generating improvements from "new construction" could also be sizeable but would have its greatest impact on commercial/industrial and agricultural properties. Since active solar energy systems already benefit from a new construction exclusion, this provision should have little impact for residential properties.

Many of the large industrial sites in California have already developed cogeneration facilities on their properties to produce electricity for their own use and as a safeguard against shutdown during power outages, and sell any excess to an energy supplier. According to the list of power plants obtained from the Energy Commission, there are more than 100 of these power generating facilities in the state. These include petrochemical refineries, other refineries, and other chemical plants, and wood and paper product manufacturers. The online megawatts (MW) produced by these facilities ranges from about 0.1 MW to nearly 150 MW. Although the existing facilities would not qualify for the "new construction" exclusion, more than likely any upgrades or modifications to these facilities would qualify. Assuming these upgrades would add an average of \$1 million in value for each site, the annual revenue decrease at the basic one percent property tax rate would be:

$$(\$1 \text{ million/site} \times 100 \text{ sites}) \times 1 \text{ percent} = \$1 \text{ million annually}$$

With rising energy costs and the threat of energy shortages, other industrial and some agricultural property owners are considering the development of their own electrical generating facilities. Based on data obtained from energy generation equipment suppliers, \$100 million will be spent annually statewide for new electrical generation facilities for dairies alone. Contra Costa reports that, overall, the assessed value of cogeneration plants in that county amounts to \$632 million. They anticipate that new plants being built in the county will result in an additional assessed value of \$350 million over the next two years.

Assuming that Contra Costa represents half of such activity statewide, the annual revenue decrease at the basic one percent tax rate for new facilities would be:

$$(\$100 \text{ million} + (350 \text{ million} \times 2) \times 1 \text{ percent} = \$8 \text{ million annually}$$

Revenue Summary

It is likely that the proposed new construction exclusion for the construction, installation, or modification of any fixture or improvement that is undertaken for the primary purpose of increasing the energy efficiency of the property will have a significant annual revenue impact. However, due to the varying factors involved and their lack of predictability, it is not possible to pinpoint the revenue effects of the energy efficiency provision of this proposal. However, a relatively conservative estimate for this part of the proposal is that

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the decrease in property tax revenues at the basic one percent property rate will grow by at least \$7 million each year.

The proposed new construction exclusion for improvements undertaken for the primary purpose of generating electricity for use on the property likely will also have a significant annual revenue impact. A conservative estimate for this part of the proposal is that the decrease in property tax revenues at the basic one percent property tax rate will grow by at least \$9 million each year.

Altogether, the estimated annual decrease in property tax revenues under this bill amounts to more than \$16 million.

Qualifying Remarks

The revenue decrease for the new construction exclusion will remain in effect until the property changes ownership, at which time the entire property will be assessed at full value.

Also, it is assumed for the purposes of this estimate that this proposal does not apply to new construction on power plants that are built for the purpose of generating energy primarily for sale or transmission to electrical energy providers.

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